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BEFORE THE
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C.

Accounting Practices --)	
Oil and Gas Producers --)	File S7-715
Financial Accounting Standards)	

COMMENTS OF THE UNITED STATES
DEPARTMENT OF JUSTICE

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INTRODUCTION

On January 4, 1978, the Securities and Exchange Commission ("Commission") published a notice in the Federal Register 1/ soliciting public comment on whether the Commission should rely on the accounting standards for oil and gas producers developed by the Financial Accounting Board ("FASB").

The Department of Justice ("Department") is the Executive Department of the United States charged by Congress with the enforcement of the Nation's antitrust laws, and has the duty of protecting the public interest in a competitive

1/ 43 F.R. 878 (January 4, 1978).

economy. As in other proceedings before federal agencies, the Department comes before the Commission to advocate the adoption of regulatory policies which will preserve and promote competition to the extent feasible under the governing laws.

Pursuant to the Securities Act Amendments of 1975, 2/ the Commission has a statutory duty to consider the competitive effects of its actions and to choose the least anticompetitive alternative available to carry out the purposes of the securities laws. Given the nature of this proceeding, the Commission's special statutory responsibilities to consider competitive effects, and the Department's role as an advocate of competition, the Department submits the following comments as an interested party.

BACKGROUND

Section 503 of the Energy Policy and Conservation Act 3/ ("EPCA") directs the Commission to "take such steps as may be necessary to assure the development and observance of accounting practices to be followed" by oil and gas producers

2/ 15 U.S.C. §78w(a)(2) (1975).

3/ 42 U.S.C. §6383.

"for purposes of developing a reliable energy data base."
Section 503 also directs the Commission to consult with the Federal Energy Administration (now the Department of Energy), the General Accounting Office, and the Federal Power Commission (whose functions have been assumed by the Federal Energy Regulatory Commission) in relation to the development of such rules. Section 503 also authorizes the Commission to prescribe rules or to rely on accounting practices developed by the FASB. EPCA directed the Commission to develop such rules by December 22, 1977, but the Commission had authority to extend the deadline on its own motion to accommodate meaningful comment with respect to whether it should prescribe such practice by rule or rely upon standards developed by the FASB.

The FASB, a private sector organization that promulgates financial accounting and reporting standards, undertook to establish accounting rules for oil and gas producing activities. On July 15, 1977, the FASB issued an Exposure Draft proposing the adoption of the "successful efforts" method of financial accounting as the sole allowable method for oil and gas producers. As adopted, the rule would require such firms to use this accounting method not only to satisfy the reporting requirements of the Department of Energy, but also to satisfy the Commission's disclosure requirements.

On September 7, 1977, the Commission published a notice in the Federal Register proposing to amend its regulations to incorporate the accounting standard proposed in the FASB's Exposure Draft, and invited the submission of comments by interested parties. On November 25, 1977, the Department of Justice submitted comments which urged the Commission to postpone the adoption of the proposed rule until it had satisfied its statutory obligation to perform an independent study of the competitive effects of such action.

Thereafter, on December 5, 1977, the FASB issued Statement of Financial Accounting Standards No. 19, "Financial Accounting and Reporting by Oil and Gas Producing Companies." Statement No. 19 affirms the tentative conclusions adopted by the FASB in its Exposure Draft, with certain modifications. One such modification is that Statement No. 19 would become effective for financial statements for fiscal years beginning after December 15, 1978, rather than for fiscal years beginning after June 15, 1978. This modification means that no company will be required to apply the standards reflected in Statement No. 19 until 1979.

On January 4, 1978, as set forth in its Federal Register Notice, 4/ the Commission, pursuant to Section 503 of EPCA, officially extended the December 22, 1977 deadline for the

4/ 43 F.R. 878. (January 4, 1978).

development of accounting standards for oil and gas producers. The period for development of appropriate standards was extended to allow for a meaningful comment period with respect to the determination of whether the Commission should rely on the standards developed by the FASB. 5/ In its solicitation of comments, the Commission requested advice on the following questions:

1. What are the most appropriate financial accounting and reporting standards for oil and gas producing activities for purposes of reporting to the DOE pursuant to the EPCA?
2. What are the most appropriate such standards for purposes of the preparation of financial statements to be included in filings with the Commission under the Federal securities laws?

In addition, the Commission solicited comments on issues relating to the competitive impact of its proposed rule. It is to the competitive issues that the Department's comments are primarily directed.

SUMMARY OF POSITION

The Commission has a statutory responsibility to consider the competitive impact of any proposed regulation. Pursuant to this responsibility, the Commission must choose the least anticompetitive alternative available to carry out

5/ 43 F.R. 879 (January 4, 1978).

the purposes of the securities laws. This responsibility also establishes a duty on the part of the Commission to affirmatively demonstrate that any burden on competition imposed by its action is necessary or appropriate to further the purposes of the securities laws.

To satisfy this burden, the Commission, if it is to rely on FASB Statement No. 19, must affirmatively demonstrate that the successful efforts accounting method is preferable to full cost or any alternative accounting systems as an accurate measure of the financial operations of all the firms to which successful efforts would apply. If the Commission cannot demonstrate that successful efforts is superior to each of the practical financial reporting alternatives in terms of disclosure, then it must show that the market effects, if any, of a mandated switch to successful efforts would not be anticompetitive. If such market effects are shown to be anticompetitive, then the Commission must demonstrate that a mandated switch to successful efforts is nevertheless necessary or appropriate in furtherance of the purposes of the securities laws. Therefore, if the Commission requires more information, more time, or both, in order to make the requisite demonstration, it should, consistent with its statutory obligation, postpone the adoption of a final rule until the requisite justification

for imposing a competitive burden can be affirmatively shown. In the meantime, of course, the Commission has, and will continue to have, the option of adopting a uniform rule limited to reporting by oil and gas producers to the Department of Energy.

I. THE COMMISSION HAS A STATUTORY DUTY TO CONSIDER
THE COMPETITIVE IMPACT OF ITS ACTIONS AND TO ADOPT
THE LEAST ANTICOMPETITIVE ALTERNATIVE

The Securities Act Amendments of 1975 ("1975 Amendments") represented a profound change in national policy with respect to competition in the securities field. As enacted in 1934, the Securities Exchange Act was virtually silent on competition. Now, under the 1975 Amendments, competition has become one of the Act's principal statutory objectives, Congress having recognized the wisdom of more explicitly and forcefully applying the Nation's "fundamental economic policy" 6/ to its crucial capital markets. The Commission is thus under an affirmative mandate to eliminate "all present and future competitive restraints that cannot be justified by the purposes of the Exchange Act." 7/

6/ *Carnation Co. v. Pacific Westbound Conference*, 383 U.S. 213, 218 (1966).

7/ Senate Report No. 94-75 accompanying S. 249, Senate Committee on Banking, Housing and Urban Affairs, 94th Cong., 1st Sess. (1975), at 13.

In addition, the 1975 Amendments require that the Commission, in making rules and regulations pursuant to any provisions of this chapter, shall consider among other matters the impact any such rule or regulation would have on competition. The Commission shall not adopt any such rule or regulation which would impose a burden on competition not necessary or appropriate in furtherance of the purpose of this chapter. 8/

Furthermore, if the Commission determines that the imposition of some burden on competition is necessary or appropriate, it must include in its rulings a statement of the reasons for such a determination. 9/

Thus, the Commission has a duty to assess the competitive effects of its regulatory proposals, and the statutory language calls for the Commission to evaluate those effects in relation to other purposes of the Act. As a result of that competitive analysis, the Commission must adopt those approaches to its regulatory goals that are the least anticompetitive alternatives.

The legislative history of the Securities Act Amendments of 1975 describes best this responsibility:

The Senate bill did not attempt to eliminate specific enumerated barriers to competition. Rather, the Senate bill charged the SEC with

8/ 15 U.S.C. §78w(a)(2) (1975).

9/ Id.

an explicit and pervasive obligation to eliminate all present and future competitive restraints that could not be justified by the purposes of the Exchange Act Further, the Commission was required to evaluate its own regulatory proposals in light of the fundamental national economic policy of furthering competition and was prohibited from promulgating any rule which imposed a burden on competition not necessary or appropriate to achieve the purposes of the Exchange Act. The Commission's responsibility under the Senate bill is to balance the perceived anticompetitive effects of a regulatory policy or decision (whether its own or that of a self-regulatory organization) against the purposes of the Exchange Act that are advanced thereby and the costs of doing so. The conference substitute accepts the Senate provisions with respect to competitive standards. 10/

In short, then, central to this proceeding is the Commission's statutory duty to: consider the competitive effects of proposed regulations in light of the purposes to be served by such regulation under the securities laws; choose the least anticompetitive alternative to effectuate the purposes of such laws; and clearly articulate the reasons for adopting any regulation that creates a burden on competition.

10/ House Conference Report No. 94-229, May 19, 1975, p. 94-95.

II. THE COMPETITIVE ANALYSIS

In this proceeding, the Commission's mandate is to vindicate two policies: one is to protect competition; the other is to insure disclosure of accurate information to investors. These policies are not conflicting. Both goals, protecting competition and encouraging meaningful disclosure for the protection of investors, may be served simultaneously. The supply of accurate information to capital markets should further the achievement of both goals. Indeed, if one method of reporting is clearly superior to all others in terms of the accuracy or reality of the picture it portrays, it cannot be said that changes in capital market behavior in response to such information would injure competition among oil and gas producers. 11/ Easy access to accurate information will help investors to make appropriate decisions regarding the efficient allocation of scarce capital. Furthermore, when the quality of information available to investors is less than optimal, markets will adjust more slowly to changed circumstances. Hence, better information will tend to improve the competitiveness of markets.

However, despite the conceptual congruence of these policies, agency action may be inconsistent with either or

11/ It should be noted that a Commission decision to change accounting rules does not automatically create an inference of anticompetitive market effects. This contrasts with Commission action which would clearly lead to such an inference; e.g., a decision to reinstitute fixed commissions for securities brokers.

both. For example, if two different reporting standards resulted in equally meaningful disclosure, a mandated switch from one to the other would not enhance the quality of information available, but it might cause structural or behavioral changes which bear on competition. In that case, agency action would certainly not be inconsistent with disclosure policy, but would be highly questionable in terms of competition policy. Obviously, if the mandated reporting change were to result in less meaningful disclosure, and also produced capital market effects that were anticompetitive, Commission action would be inconsistent with both policies. On the other hand, if there were no anticompetitive effects, and the impact on disclosure would be neutral, or even negative for that matter, then the Department would be indifferent as to any action taken by the Commission with respect to accounting practices. Accordingly, to satisfy its statutory duty, the Commission must determine whether successful efforts is superior to other practical reporting alternatives in terms of meaningful disclosure and whether, apart from the merits of these accounting systems, the mandated change from full cost to successful efforts would have anticompetitive consequences for oil and gas producers.

As an initial matter, then, the Commission will need to determine which of the available accounting methods supplies the market with the best information. Each method will therefore be discussed in turn.

A. Disclosure Issues

1. "Successful Efforts"

The successful efforts method of accounting, among other things, involves the expensing of exploratory dry holes. 12/ The effect of this immediate expensing is a depression of present earnings. Justification for such a system derives from the belief that, as in other areas of accounting, costs may not be capitalized unless they relate to "assets having identifiable future benefits." 13/ Because, it is argued, no future benefit accrues from a dry hole, capitalization of the costs incurred to drill that hole is precluded.

Several criticisms have been leveled against the successful efforts approach regarding its "disclosure" capabilities. First and foremost, it is contended that successful efforts does not conform conceptually to the nature of the oil and gas exploration industry. 14/ An accounting method which serves to illustrate financial

12/ Statement of Financial Accounting Standards No. 19 (December 1977), ¶16-20 at 5-6.

13/ Id., ¶143, at 72; ¶177, at 86.

14/ Statement of John S. Chalsty (Donaldson, Lufkin & Jenrette) before the Department of Energy's Inquiry on Financial Accounting Standards, at 4-6, February 21, 1978.

reality in the oil and gas exploration and production industry should not overemphasize costs. Success or failure of a company is a function of the company's ability to find and develop reserves in quantities sufficient to result in a return on the totality of capital invested, not a well-by-well cost/benefit analysis. 15/

A second criticism which has been made of the successful efforts approach is that it arbitrarily categorizes expenditures for purposes of being either expensed or capitalized on the occurrence of the event of finding reserves. It is argued that, under this system, the order in which wells are drilled will have a significant impact on the company's financial picture. 16/ By way of illustration, assume a company drills ten holes in a field. If the first of the ten holes is successful, each of the nine subsequent wells will be capitalized, as they are considered part of the "development" of a known asset. In contrast, if the successful hole were drilled last, each of the preceding dry holes would have to be expensed as being unrelated to the defined asset, the successful hole. This result appears incongruous, and the respective balance sheets would not distinguish between the apparent "success" of the first venture and

15/ Alternative Concepts - Full Cost and Successful Efforts, Public Record, Volume 1, Section A, at B-10 (1978).

16/ Statement of Financial Accounting Standards No. 19 (December 1977) (Dissent of Mr. Litke) at 35.

"failure" of the second. Risks were identical, costs were identical, reserves discovered were identical, and yet the information disclosed varied widely.

These arguments would appear to cast doubt on the disclosure capabilities of the successful efforts method. While attempting to bare the risks of exploration to the investor, this approach may be misleading. Stating that the successful efforts technique results in a more "conservative" approach is only a valid argument so long as it can be determined that the method is accurate. Otherwise, conservatism is, in effect, merely a policy of deliberate understatement.

2. "Full Cost"

The full cost method, presently used by a substantial number of small exploration and development companies, capitalizes costs incurred in exploration. In this system a "cost center" is used, either on a country, continent, or company-wide basis, within which costs are amortized when reserves are produced. The earnings stream of the company is rendered comparatively stable using this approach. A limitation on this method is that the amounts capitalized may not exceed the value of the reserves found. ^{17/} In its broadest sense, this limitation may satisfy the FASB require-

^{17/} Statement of Financial Accounting Standards No. 19 (December 1977), ¶104, at 58.

ment that costs relate to "assets having identifiable future benefits" before they are capitalized. 18/

Full cost, it seems, is also sharply criticized for its inability to provide adequate disclosure for investors. Initially, it suffers from the same conceptual problem as successful efforts, i.e., it attempts to portray the financial picture of a company in terms of historical cost rather than true value.

More importantly, though, the system has been criticized for allegedly obscuring risks associated with oil and gas exploration. 19/ Not only are costs spread out over a long period of time with this method, but the impact of failure (a dry hole, field, or country) is diluted by successes in totally unrelated areas within the cost center.

Furthermore, there is feared the possibility that cost centers will be manipulated by companies so as to alter the resultant earnings picture. An increase in the size of a cost center, for example, would raise the limit on capitalizable costs. Such manipulation would certainly not be consistent with an attempt by the Commission to implement the most accurate system possible. Unless a cost center were defined with reasonable precision, investors would not have a suitable basis for comparison.

18/ See discussion supra at p. 12.

19/ Statement of Financial Accounting Standards No. 19 (December 1977), ¶149-151, at 74-75.

In spite of these concerns, an argument can be made that full cost accounting closely represents the true worth of a company's reserves. ^{20/} This position, which assumes a company-wide cost center, maintains that while it is not possible to predict with certainty which holes will be dry, nevertheless, there is a correlation between the acquisition, exploration and development costs and the finding of reserves. To state it more precisely, the present discounted value of reserves is roughly equivalent to the costs of exploration and development, plus lease bonus payments. Companies bid on leases by estimating the value of reserves and the costs associated with producing those reserves. A bonus payment brings the anticipated costs up to the level of projected worth. It can, therefore, be considered an equalizing factor in the equation for the industry.

If companies expect to spend less on total exploration and development than the expected present discounted value of reserves, lease bonus payments will tend to rise until expenditures equal the expected present discounted value of reserves for the industry as a whole. Similarly, if expenditures increase, bonus payments for the industry can be expected to fall to a level where there will once again be equivalency with present discounted value.

^{20/} See, Statement of Professor Walter J. Mead before the Department of Energy's Inquiry on Financial Accounting Standards, February 17, 1978. For a contrary opinion, see Statement of Financial Accounting Standards No. 19 (December 1977), ¶185 at 89-90.

Essentially, then, the full cost system is claimed to be superior because of its closer relationship to true value over time. The problem presented by this approach is its extensive use of aggregate figures. It is only over the long run that the industry as a whole can expect its lease bonus payments to balance the costs of drilling with the value of reserves. The same point can be made with equal force regarding individual companies. Moreover, to the extent an individual firm deviates from the average company in the industry in its ability to find oil or gas, this method will distort the company's worth. It is only after a number of years that companies can be expected to approach industry averages.

3. Value Accounting

A third accounting alternative, discovery value, involves the estimation of mineral reserve value at the time of discovery. This method, as well as current value accounting, attempts to directly compare or match the costs of drilling with expected revenues generated from discovered reserves. In that sense these methods are conceptually superior to methods based upon historical cost. Unfortunately, however, these techniques can be criticized as involving a great deal of estimation and subjective

judgment. 21/ Many argue that it is not feasible to implement a true value approach at this time because of these inherent uncertainties. 22/ The Department recognizes the advantages of a true value accounting method, but also appreciates that there are practical problems which may hinder implementation.

4. The Perceived Need for Uniformity

Wholly apart from arguments regarding the merits of the various accounting methods is the desirability of a uniform system. It is claimed that uniformity of reporting will better allow investors to compare the companies in the industry. Even if one system were not demonstrably superior, it is asserted, the benefits to be derived from adopting a single standard would warrant choosing one. However, uniformity as a goal can only claim superiority where like entities are being compared. If two entities or groups of entities were significantly dissimilar, attempts to draw simple accounting comparisons would only confuse the analysis.

21/ Statement of Financial Accounting Standards No. 19 (December 1977), ¶133 at 69.

22/ Id.

For example, some full cost advocates contend that, at least with regard to successful efforts, one uniform standard of accounting would be inappropriate as it would have a disproportionate effect on one segment of the industry. That segment consists of companies heavily engaged in exploration, 23/ as opposed to production of oil and gas. The argument is that successful efforts, because it forces immediate expensing of dry exploratory holes, tends to impact exploration oriented companies to a greater extent than production oriented companies. If this difference in treatment is not reflective of the differences in risks between the two types of companies, but is rather due to an accounting policy which encourages understatement, exploration companies would appear to be disadvantaged in proportion to the intensity of their exploration efforts. The earnings pictures of companies would not simply be reflecting differences in the number and magnitude of exploration projects under this view.

The rebuttal to this concern has been that a switch from full cost to successful efforts will not prejudice the switching companies because investors "look through" earnings.

23/ An exploration company sells or leases the oil it finds to production oriented firms. Major oil companies often obtain properties suitable for production in this way.

However, assuming that to be true, the contention also supports the argument that maintenance of the status quo will not impede comparability. Consequently, if the Commission determines that a single accounting method is required, it should first find that the system will be applied to similar entities in a uniform manner and that uniformity serves a valuable function.

In light of the foregoing, we cannot say on the basis of the present record that either successful efforts or full cost is clearly the superior method of accounting for disclosure purposes. Each system presents distinct problems in converting exploration and development activities to balance sheet figures. However, supplemental disclosure of information, such as reserve data, could help to mitigate the harshness of either method. Ideally, a true value method would seem best, but implementation of such a system appears impractical.

Absent a demonstrable advantage in using one particular system, the Commission must determine whether the proposed mandated switch would likely affect capital market behavior in ways which would significantly disadvantage the competitive viability of any segment of the oil and gas producing industry and thus, whether implementation of a uniform method for financial disclosure ought to be postponed.

B. Competitive Issues

Since the proposed establishment of successful efforts as a uniform system of accounting would be the result of agency compulsion, not voluntary action, the Commission has a duty to examine the possible competitive effects of its decision. Essentially, the competitive inquiry turns on whether a mandated change from full cost accounting to successful efforts would impair or impede the access of competitively significant oil and gas producing companies to funds in the capital markets. Answering this question requires analysis of oil and gas production firms, the relationship of such firms to capital markets, and the behavior of such firms in response to perceived changes in investor attitudes.

It is uncontested that a switch from full cost accounting to successful efforts will cause a change in reported earnings and net worth for those companies that must alter their accounting methods. The extent of the change is, as yet, unclear, but present estimates indicate a fairly substantial decrease. 24/

24/ As a result of a questionnaire mailed to oil and gas producers, Touche Ross & Co. determined, inter alia, that over the past five years a switch to successful efforts would have caused a 31% drop in Retained Earnings, a 20% decrease in Net Earnings and a 16% reduction in Stockholders' Equity. Pennzoil, as a specific example, has estimated that implementation of the successful efforts method would result in a 35% decrease in Retained Earnings, and a 20% decrease in Total Shareholders' Equity. Letter of Comment, N. J. Luke, Pennzoil Company, Submission No. 77 at 737 (September 21, 1977).

A change in those figures does not, however, lead inexorably to the conclusion that a commensurate amount of harm will occur. Several intermediate determinations must initially be made to provide a foundation for a Commission conclusion that competitive injury is likely.

The first determination which must be made is that independent oil companies 25/ generally and full cost companies specifically comprise a competitively significant segment of the oil and gas exploration and development industry. If the companies that might be detrimentally affected by an accounting rule change are already a de minimus competitive factor in the market, then competition would not likely be injured by any further handicap to such companies. However, the facts show that the companies which may be injured are competitively significant.

It has been demonstrated that a very large proportion of exploratory wells drilled, are initiated by independents. 26/

25/ Our inquiry centers on independent firms because, in major integrated oil companies, exploration represents a relatively small portion of overall activity. Furthermore, most of the majors presently use successful efforts and therefore will not be forced to change their accounting method. As a result, the earnings picture for major integrated companies would be unaffected by the FASB proposal.

26/ Present estimates indicate that between 85% and 90% of all exploratory wells are drilled by independents, i.e., companies without refining or marketing activities. Statement of Arthur D. Little, Inc. before the Department of Energy's Inquiry on Financial Accounting Standards, at 3, February 21, 1978. Statement of Dr. Edward Erickson before the Department of Energy's Inquiry on Financial Accounting Standards, at 2, February 22, 1978.

Although these include a substantial number of small firms, approximately 500 companies are publicly owned and account for a majority of the drilling. 27/ Of those which are publicly held, 150 producers have been identified as using the full cost accounting method. 28/

Present data seems to indicate that the full cost firms account for a significant portion of the total production of crude in the United States. 29/ In addition, those companies have actively participated in bidding for Outer Continental Shelf (OCS) tract leases, with a high percentage of success. 30/ Therefore, based upon currently available information, the Commission would have to conclude that these companies represent a competitively important segment of the petroleum industry.

The second step in this analysis is to ascertain whether and to what extent such independent companies require equity financing from capital markets. As the following discussion

27/ These 500 companies account for roughly 60% of the drilling activities. Id., at 5.

28/ Statement of Dr. Erickson, supra n. 26, at 4.

29/ On the basis of information tabulated for 93 full cost companies, Erickson estimates that they account for 7.3% of total crude production and 16.6% of total material gas production. Those figures increase to 25% and 45% respectively when those 93 firms' production figures are confined to the independent sector alone. Id.

30/ "One or more full cost companies have participated in 64.9 percent of the winning bids (172 out of 265) for the OCS tracts leased." Id.

indicates, it is only equity financing that might be negatively impacted by an immediate depression of depicted earnings brought about by an accounting rule change.

The overwhelming number of companies engaged in oil and gas exploration are small, privately owned companies. 31/ These companies, consequently, are not subject to disclosure requirements, nor do they look to capital markets for financing: Of the remaining companies, i.e., those which are publicly held, the principal means of obtaining financing is through bank debt. Balance sheet changes will have very little impact on this category of financing, as loans are made on the basis of reserves, not depicted earnings. 32/ Financing generated by the use of limited partnership drilling funds would also remain unharmed by a change in accounting method because this form of investment contemplates immediate expensing for tax purposes.

Nevertheless, substantial amounts of money raised by independents are generated in the capital markets, including long-term debt common equity and convertible securities. 33/ Over three billion dollars has been raised by the industry in this manner during the last 10 years. It is also of interest that, as a group, full cost companies

31/ Approximately 4,500 of the 5,000 operators are in this category. Statement of Arthur D. Little, Inc., supra n. 26, at 5.

32/ Id. at 7.

33/ Statement of Joseph S. Frelinghuysen, Jr. (First Boston Corp.) before the Department of Energy's Inquiry on Financial Accounting Standards, Exhibit II at 7, February 21, 1978.

have relied upon debt, common stock and convertible securities to a much greater extent than companies using successful efforts. 34/

The foregoing underscores the heavy reliance upon outside financing by independent firms actively engaged in petroleum exploration and production. It then remains to be seen whether a mandated change from full cost to successful efforts would somehow disturb or interfere with that funding.

Within the category of market financing, debt may be distinguished from equity. The former is most often a secured fixed obligation; hence, it is not dependent upon depicted earnings to any great extent. More importantly though, this type of financing is usually facilitated by sophisticated professional analysts (e.g., underwriters, brokers, etc.). 35/ Their judgment is based upon the evaluation of, among other things, cash flow data and reported reserves, two figures which will remain unchanged by the adoption of successful efforts. A switch to successful efforts would not, then, cause them to change their investment or lending policies to any significant degree.

34/ Id.

35/ Interviews conducted by Professors Nelson (Columbia) and Brock (North Texas State University) with 30 individuals associated with banks, securities firms, rating agencies and other financial institutions generally acknowledged that depicted earnings did not affect investment decisions. Several interviewees, however, stated that earnings changes affected some investors. Interview Project Report, at 6 (1977).

It therefore becomes evident in light of these factors that equity capital, in the form of common stock and convertible securities, constitutes the area of principal concern. While the focus on the scope of financing has been narrowed considerably, it should not be concluded that the amounts of money generated are insignificant. Indeed, during the past ten years independents have apparently raised \$1-1/2 billion through the issuance of these securities. 36/ And companies using the full cost system accounted for approximately two-thirds of that amount.

We then come to the overriding concern: will imposition of an accounting change from full cost to successful efforts by the Commission cause a significant effect in the market for equity capital. Companies which are contesting the switch argue that earnings information is used by a segment of the investment public in the equity markets. They also contend, as was stated previously, that the successful efforts method of accounting will not be evenhanded as applied. 37/ Moreover, uneven application would occur not because of a greater perceived risk attributable to exploration companies but rather from the understatement bias of the accounting technique.

36/ Statement of Frelinghuysen, supra n. 33 at Exhibit II.

37/ See discussion of uniformity, supra at 18-20.

Assuming these contentions to be correct, it would follow that exploration companies would be disadvantaged in their search for equity capital in the marketplace. Moreover, smaller non-integrated companies would be placed at a greater disadvantage because exploration accounts for a larger proportion of total expenses. Their earnings would show a high degree of volatility, reflecting the timing of those outlays. Secondly, entry into or expansion within the exploration market would be made more difficult when it became evident that a company beginning exploratory operations might need to sustain an extended period of loss on its balance sheets. And finally, it is claimed that presently existing obligations which are based on price-earnings ratios, such as bank loans, could be affected by a radical change in those figures.

There are, however, several factors which must be considered as possibly indicating that no such harm would occur. The first point which would militate against a finding of competitive harm derives from the "efficient market theory." The existence of a efficient market means that prices of stock will "fully reflect" all of the publicly available data 38/ because market prices are determined by sophisticated

38/ W. Beaver, What Should Be The FASB's Objectives? Journal of Accounting at 51 (August 1973). As used here the efficient market theory means that market prices reflect current, published information, rather than inside information or past market trends.

professional investors. There have been several attempts to quantify the market effect when there were changes in accounting rules. 39/ With respect to the prospective mandated change from full cost to successful efforts accounting, an analysis of stock market price fluctuations after the release of the FASB exposure draft was undertaken by Professor Thomas Dyckman. 40/ Professor Dyckman found that, consistent with the principle of an efficient market, stock prices for those companies potentially affected by the change were not adversely impacted.

One rationale for the findings of Professor Dyckman is that, because of an efficient market, the sophisticated professional segment of the market provided support to those less informed individuals who might be tempted to rely upon depicted earnings. However, an equally valid interpretation of these findings is that the absence of detrimental effect indicated the accuracy of the former accounting method.

39/ Compare R. Eskew, An Empirical Examination of the Interaction Between Accounting Alternatives and Share Price in the Extractive Petroleum Industry, The Accounting Review, at 316-324 (April 1975) with D. Collins and M. O'Connor, Accounting Principle Formulation and Investor Reaction (April 1975).

40/ Professor Dyckman's study is contained in Report on the Effect of the Exposure Draft on the Returns of Oil and Gas Company Securities (1977). We have not undertaken to evaluate the validity of the methodology used by Professor Dyckman in his analysis.

And another possible explanation for the absence of adverse impact is the caution exhibited by the investing public -- the analysis concerned market responses to the FASB's Exposure Draft, i.e., any effects would not be evidenced until mandatory implementation of the change. 41/

Another way to determine whether a mandated change of accounting technique would result in competitive harm is to measure the present status of various successful efforts companies. Since some exploration and development firms (non-majors) already use successful efforts, it would be useful to evaluate their methods for raising capital. In that way, the Commission might better predict the effects on full cost companies after the change becomes effective.

One telephone survey 42/ found that the managements of successful efforts companies voiced no difficulty whatsoever in obtaining financing for exploration activities. However,

41/ At the present time companies are required by the Commission to disclose the projected impact of the change, albeit in general terms. See SEC Staff Accounting Bulletin No. 16, 42 F.R. 44983 (September 1, 1977). Disclosure of this information could cause a noticeable effect on the stock prices of companies subject to the change.

42/ These inquiries were conducted by Professor Brock (North Texas State University) and consisted of conversations with officers of twenty-seven successful efforts companies.

those companies almost invariably sought financing from sources other than the equity markets. This lack of equity funding may indicate an acknowledgment by those companies that such funding would be more difficult or expensive. On the other hand, it may reflect the general unimportance of equity capital to exploration and development firms -- a fact which, if true, would negate the importance of any particular accounting method to the competitive ability of independent oil and gas producers. Given these possibilities, the Commission must determine whether successful efforts companies merely prefer sources of financing other than equity or, rather, must rely upon alternative means.

The final stage of the analysis concerns the possible changes in managements' behavior in anticipation of changes in investor attitudes brought about by the adoption of successful efforts. It has been asserted that because of a perceived need to avoid the impact of the accounting change, management of firms subject to the change will modify their behavior. 43/ Examples of possible changes in conduct would be the alteration of drilling schedules to better time the

43/ See, e.g., Statement of H.A. Nelson (Nelson Petroleum Company), before the Department of Energy's Inquiry on Financial Accounting Standards, at 7-8, February 21, 1978.

impact on balance sheets and thereby minimize fluctuations; elimination of some high-risk drilling altogether; or mergers with non-exploration oriented companies to cushion the long-term impact of the switch to successful efforts.

Contemplated actions of this kind taken by full cost managements no doubt reflect a belief that accounting influences capital markets. The record shows that such belief is sincere. The Department's view of such attestations is that they are probative, although not conclusive, of the relationship between depicted earnings and the ability to raise equity capital. The perceptions of those who depend on such sources of capital must be given weight. On the other hand, as pointed out above, the competitive inquiry cannot end with such testimony. Simply put, management perceptions may not accurately reflect capital market imperfections. Similar complaints could be heard even if disclosure were to be made more meaningful by the mandated change. Similarly, management decisions to reduce or eliminate certain exploration, while perhaps inconsistent with national energy policy, would not be an anticompetitive result if they were brought about by capital market responses to more accurate information.

Finally, it is hard to envision any change in accounting as having more than a temporary effect on management, in the absence of a distorting impact on information available to investors.

CONCLUSION

The Commission has responsibility for the establishment of a uniform standard of accounting for national energy data base purposes. It is clear that the establishment of that uniform system for disclosure purposes as well requires the Commission to consider the competitive impact of such proposed action.

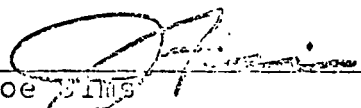
A serious question has arisen as to whether a regulation which mandates a change to one method of accounting for financial reporting as well as data base reporting will harm a competitively significant segment of the petroleum industry. In promulgating financial accounting principles, then, competitive impact must also be factored into the Commission's decision. To satisfy its statutory responsibility, the Commission must find that the accounting method chosen for uniform application is superior to other feasible alternatives, that no competitive harm will result, or that any such harm which may result is justified in light of the purposes of the securities laws.

The Department submits that, on the current record, it cannot be reasonably found that successful efforts is a superior method of accounting for oil and gas producers or that such method should be applied to all firms. Moreover, inadequate information exists on the relative dependence of oil and gas producers on equity capital to permit a reasonably confident assessment of the competitive consequences of

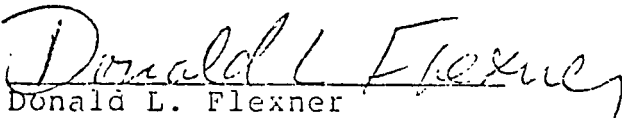
the Commission's reliance on the accounting standards developed by the FASB. Given the competitive significance of firms now using full cost accounting, the Commission is bound to conduct further fact finding before it adopts the FASB rule. Until record deficiencies concerning the competitive issue can be cured the Commission should, consistent with its statutory obligations, postpone the adoption of a final rule. A uniform system for data base purposes may still be achieved independently where the requisite justification for a single financial reporting system is lacking.

Respectfully submitted,

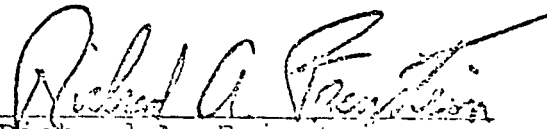
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